CalPERS

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September 15, 2008

AGENDA ITEM 8a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: International Fixed Income Managers Annual Review

II. PROGRAM: External International Fixed Income

III. RECOMMENDATION: Renew the contracts for all CalPERS' external international fixed income managers for a period of one year. Wilshire Associates' opinion letter is shown in Attachment 1. Wilshire Associates' disclosure letter is shown in Attachment 2. The five managers are:

Alliance Bernstein L.P.
Baring Asset Management
Mondrian Investment Partners
PIMCO
Rogge Global Partners

IV. ANALYSIS:

Background

CalPERS implemented the international fixed income program in May 1989, to provide diversification and achieve efficient frontier objectives in the CalPERS investment portfolio. The assets under management as of June 30, 2008 were approximately $4.72 billion.

The international fixed income program currently consists of five managers: one hired in October 1989; another hired in August 2000 and funded in September 2000; and three that were hired and funded in the first quarter of 2007. Two other managers, Brandywine Global and Western Asset Management resigned their mandates during the last fiscal year. All managers are under one-year annual review contracts.

Staff completed an RFP in August 2006, and the Investment Committee approved six finalists for the spring fed pool. Of the six managers approved, four were funded between February and April 2007.

At the March 12, 2007 Investment Committee meeting, the IC approved changes in principle to the International Fixed Income Policy to include moderate leveraging, shorting, exposure to the U.S. fixed income markets and high yield securities. Subsequently, the Policy Subcommittee approved Staff's recommended changes to the Policy at the April 13, 2007 meeting with full Investment Committee approval at the May 14, 2007 meeting. As of June 1, 2007 the managers have been permitted to use these strategies. A review of these strategies is provided in this document.

Recommendation

Staff recommends renewal of the contracts of Alliance Bernstein L.P., Baring Asset Management, Mondrian Investment Partners, PIMCO, and Rogge Global Partners for a period of one year. Each contract contains a provision allowing for termination by either party with 30 days notice.

In what follows, the past year's market environment and the overall program performance are discussed first. Discussion of managers' individual performance begins on page 8.

Wilshire's opinion letter is Attachment 1.

Market Environment

The one-year review period ending June 30, 2008 was characterized by slowing global growth driven in large part by a severe credit crisis and continued weakness in the U.S. housing market. In addition, global inflationary pressures intensified, rising further from the top end of most central bank target zones due to rising food and energy prices. Under these competing influences, global central banks' policies diverged. To address weak growth and tighter credit conditions, the U.S. Federal Reserve, the Bank of England, the Bank of Canada and the Reserve Bank of New Zealand all cut policy rates. In contrast, the European Central Bank and many emerging market central banks opted to raise policy rates to counter the perceived inflationary threat.

As the U.S.-centered credit crisis intensified, market participants began to question the solvency of many financial institutions, adding to the already tight credit conditions and causing the prices of risky assets to fall. Government bonds rallied as investors sought safety and liquidity. Investors in mortgage

backed and corporate securities suffered large losses. Geographically, these risky assets in the U.S. generally underperformed those of other countries and traded at severely depressed levels.

Table 1 below shows the currency hedged performance between a duration neutral treasury bond and several global indexes including a global securitized asset index and a global corporate index. As can be seen in the table, the performance of risky assets lagged the favored government bond sector. Investors holding any allocation to those risky assets over the review period would have seen their performance trail an all government bond index such as CalPERS' international fixed income index.

Table 1

Bond Market- U.S. dollar returns	Annual total return year ending June 30, 2008
Duration Neutral U.S. Treasury	8.09%
Lehman Global Corporate Index	1.16%
Lehman Global Securitized Index	5.88%

Source: Lehman Brothers and CalPERS

Currency movements had a positive impact on the index performance during the period July 1, 2007 to June 30, 2008. The major component currencies of the index, the Euro (46%), the Japanese Yen (36%) and the British Pound (6%) all rallied vs. the U.S. dollar. A reasonable proxy for the index currencies, the U.S. dollar index, slid by 8.3% during the period. Of the constituent components, the Euro appreciated by approximately 10.5% and the British Pound rallied by 1.3%. The Japanese Yen finished the period stronger by 6.1%. The U.S. dollar value was driven lower by the weakness in the domestic economy and the resulting easier monetary policy stance by the Fed, as well as the perceived riskiness of the U.S. financial system. A manager's allocation to the U.S. dollar away from foreign currencies would have acted as a drag on the manager's performance relative to that of an index with no U.S. dollar exposure such as the CalPERS international fixed income index.

Assets Under Management

As of June 30, 2008, total assets under management for the CalPERS international fixed income program were approximately $4.72 billion. Table 2 on the following page shows the corresponding assets managed by each manager.

Table 2

Manager	Portfolio Value (in millions)	Percent of Portfolio
Alliance Bernstein LP	$1,260.30	26.69%
Barings Asset Management	$132.70	2.81%
Mondrian Investments	$903.90	19.15%
PIMCO	$1,241.50	26.28%
Rogge Global Partners	$1,184.20	25.08%
Total	**$4,721.60**	

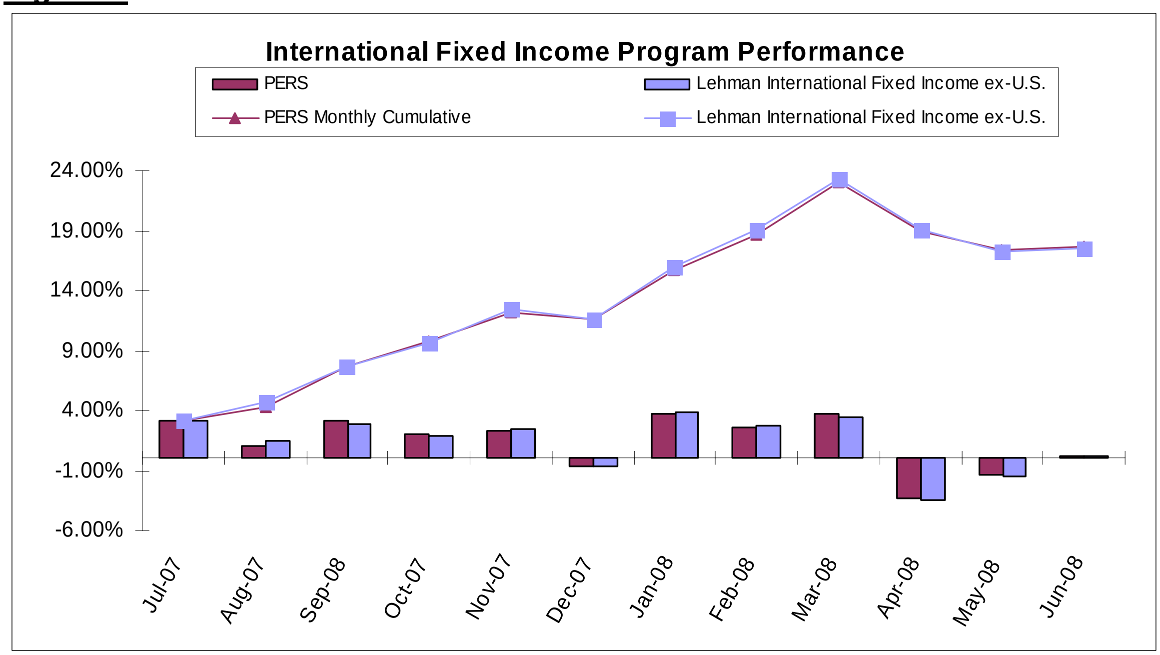
Source: State Street Bank and CalPERS

Program Performance

The strategic objective of CalPERS' international fixed income program is to provide diversification and enhance the CalPERS investment portfolio with respect to efficient frontier objectives. The objective of the external managers is to outperform the Lehman International Fixed Income Index, net of all management fees. All performance results are shown net of fees.

Over the review period ending June 30, 2008, the Program outperformed its benchmark by 0.14%, returning 17.63% vs. 17.49% for the index. Below, Figure 1 shows the monthly performance of the program and the index over the one year review period.

Figure 1

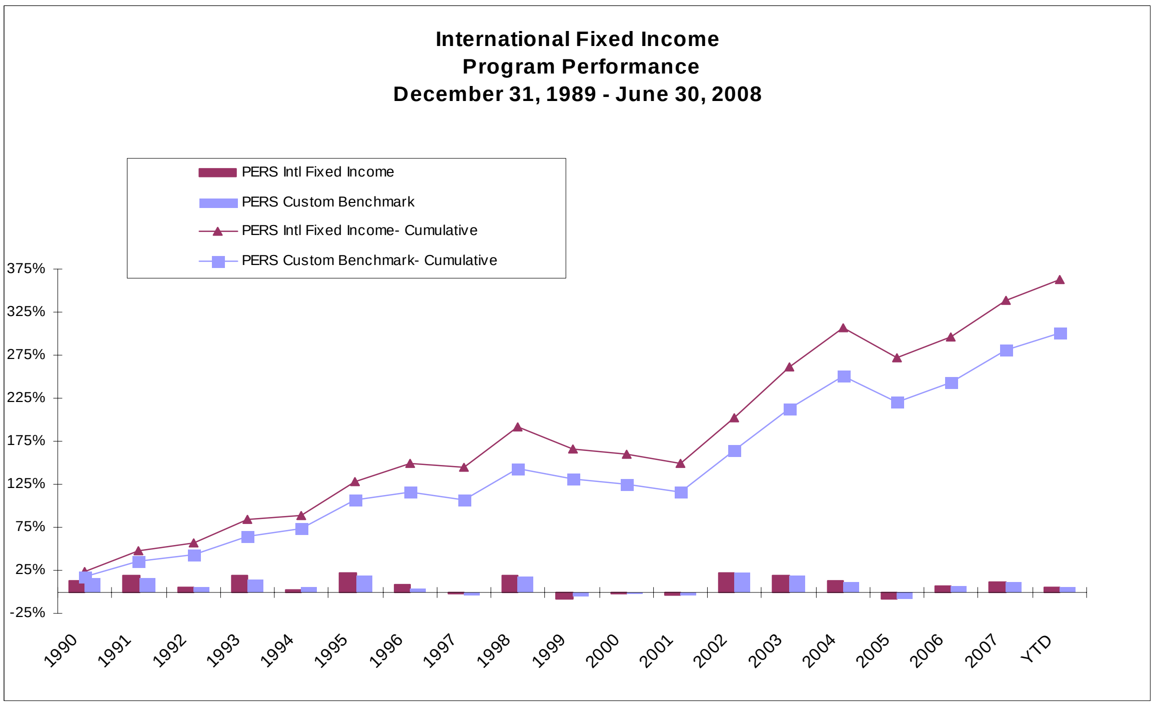


Source: State Street Bank and CalPERS

Since inception in October 1989, the program has outperformed it's benchmark by 0.81% on an annualized basis, returning 8.33% per year on average vs. 7.52% for the index. On a cumulative basis, the Program has added 61.89% over its benchmark over the same period.

Figure 2 below illustrates the annual and cumulative performance of the Program and the index since the inception date.

Figure 2



Source: State Street Bank and CalPERS
Note: Prior to June 30, 2004 the PERS custom benchmark was the Citigroup World Government Bond ex U.S. index. Subsequently, the Lehman International Fixed Income ex U.S. has been used.

Below, Table 3 shows the information and Sharpe ratios for the total International Fixed Income Program over the three and five year periods, which include results from managers that have resigned over time. The one-year information and Sharpe ratios for the program with the manager line-up as it currently exists would have been 1.76 and 0.13 respectively.

Table 3

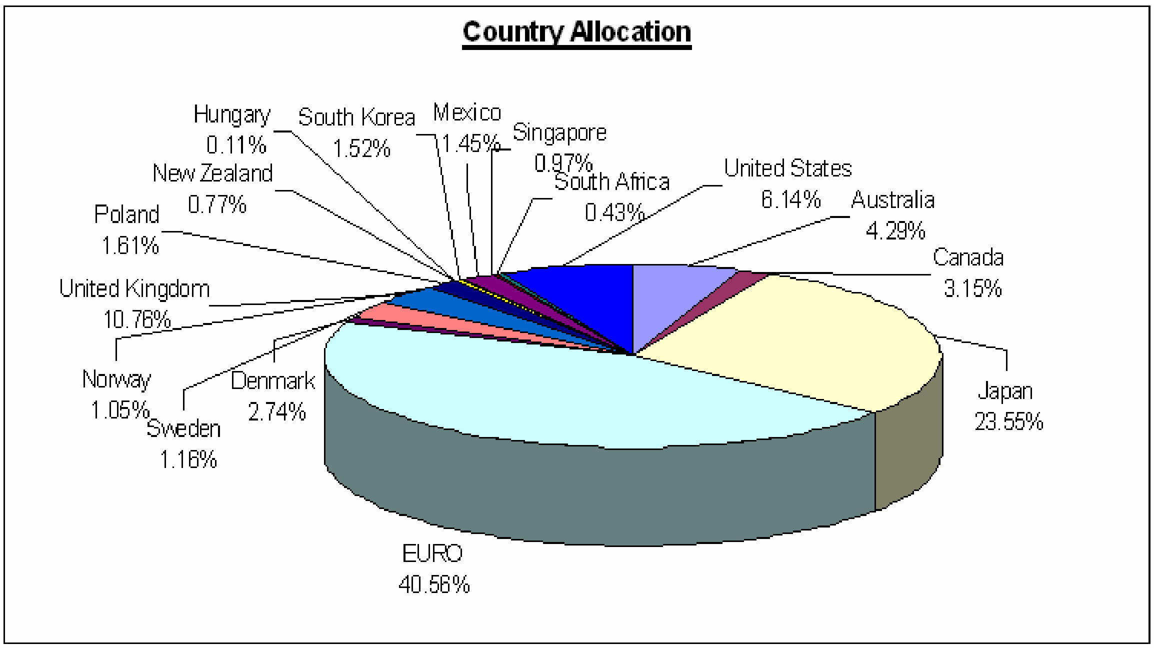
	Average 3 year Information Ratio	Average 3 year Sharpe Ratio	Average 5 year Information Ratio	Average 5 year Sharpe Ratio
Total International Fixed Income	-0.38	-0.03	0.04	0.00

Source: State Street Bank and CalPERS

Country Exposures

The aggregate country exposure of CalPERS' international fixed income program as of June 30, 2008 is shown in Figure below. This chart separates the bond holdings by country, demonstrating the diversification being provided by the program through a number of liquid foreign bond markets.

Figure 3



Source: CalPERS International Fixed Income Managers and CalPERS

Shorting and Leverage Summary

On June 1, 2007, CalPERS permitted the international fixed income managers to use moderate amounts of leverage and shorting with limits set at 130% and 30% of notional value respectively. With regard to leverage, Staff employed a very conservative accounting definition of leverage in order to limit the amount risk taken on by managers.

Staff's review of the impact from leverage and shorting examined strategies only from the embedded leveraged or short position, ignoring unlevered legs of a trade. This partial impact of leverage and shorting may not completely reflect the true intent of managers when they are expressing a relative value trade. The true value of a relative value trade requires examining both positions in a trade. This review examined the impact only from the five managers reviewed in this item.

Since managers have been permitted to use these strategies, there have been two typical uses of leverage and shorting. The first use is to implement a strategic view such as outright country views, yield curve trades or sector rotation trades. Managers implementing strategic views typically use limited amounts of leverage, on a more occasional basis. The second use is beta magnification – i.e., adding or subtracting exposure beyond what assets or benchmark weights allow. Managers employing beta magnification usually run at close to maximum leverage levels.

In general, **the leverage and shorting ability has had a positive impact on alpha with no additional risk at the program level**. The total program level value added is approximately 0.58%. Table 4 below shows the composite level tracking error since leverage and shorting were permitted vs. the previous period and shows that tracking error at the program level has fallen slightly since the change. In short, the program increased alpha while decreasing risk, resulting in a higher information ratio.

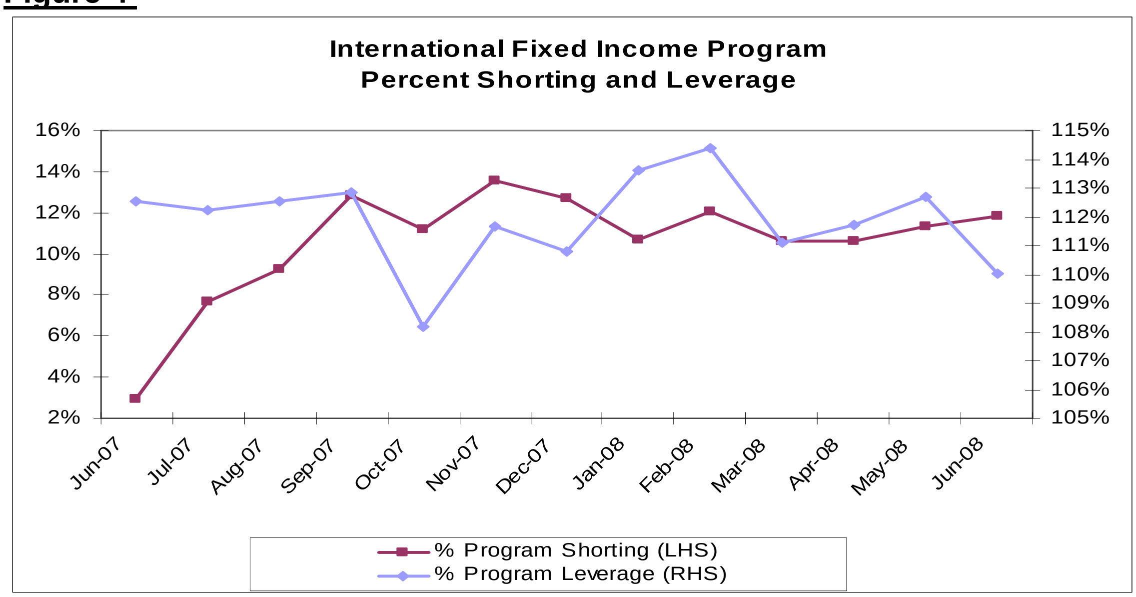
Table 4

Period	Tracking Error
September 1, 2000 through May 31, 2007	73.4 basis points
June 1, 2007 through June 30, 2008	68.0 basis points

Source: CalPERS

Below, Figure 4 shows the composite level amounts of leverage and shorting employed over the review period.

Figure 4



Source: CalPERS

In general, it appears that **leverage and shorting are useful tools for the program**. Reducing risk while increasing return, this is the concept of delivering more intelligent risk that staff advocated to the Investment Committee at the March 12, 2007 meeting, when the changes were adopted.

Manager Performance Summary

As outlined earlier in the market environment section, government bonds were heavily favored relative to risky assets during the review period. This made for performance below the benchmark by managers who allocated away from government bonds, which comprise all of the Lehman International Fixed Income Index. This makes the overall program's outperformance all the more noteworthy, since the managers, as a group, did allocate away from government bonds.

Below, Table 5 below shows the performance of each of the investment managers over the one-year review period and since inception.

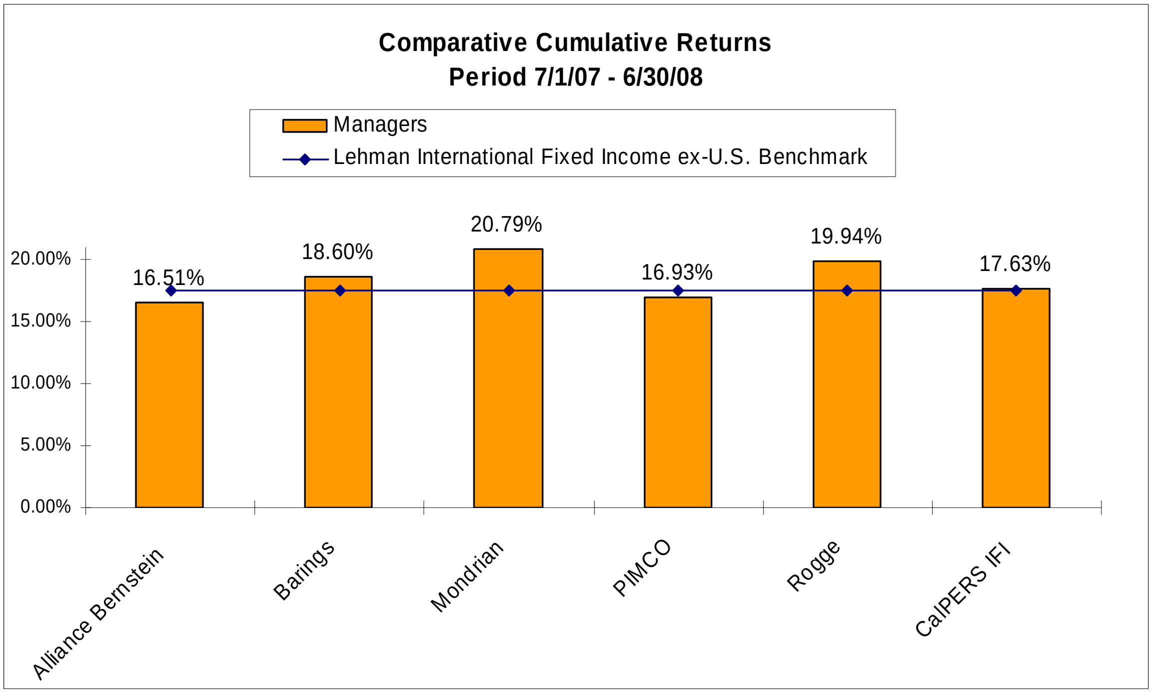
Table 5

Active Managers (Inception Date)	1 Year Portfolio Performance (Sept 06 – June 07)	Benchmark Performance	1 Year Excess Return	Since Inception Portfolio Performance	Since Inception Benchmark Return	Since Inception Excess Return
Alliance Bernstein (Feb 2007)	16.51%	17.49%	-0.98%	12.60%	12.89%	-0.29%
Baring Asset Management (Oct 1989)	18.60%	17.49%	+1.11%	9.03%	7.72%	+1.31%
Mondrian Investment Partners (Mar 2007)	20.79%	17.49%	+3.30%	13.69%	11.71%	+1.98%
PIMCO (Apr 2007)	16.93%	17.49%	-0.56%	11.37%	12.21%	-0.84%
Rogge Global Partners (Sept 2000)	19.94%	17.49%	+2.45%	8.58%	8.16%	+0.42%

Source: State Street Bank and CalPERS

On the next page, Figure 5 compares the returns of the managers and the program as a whole to the benchmark over the one-year review period. Individual manager performance will be discussed later in this item.

Figure 5

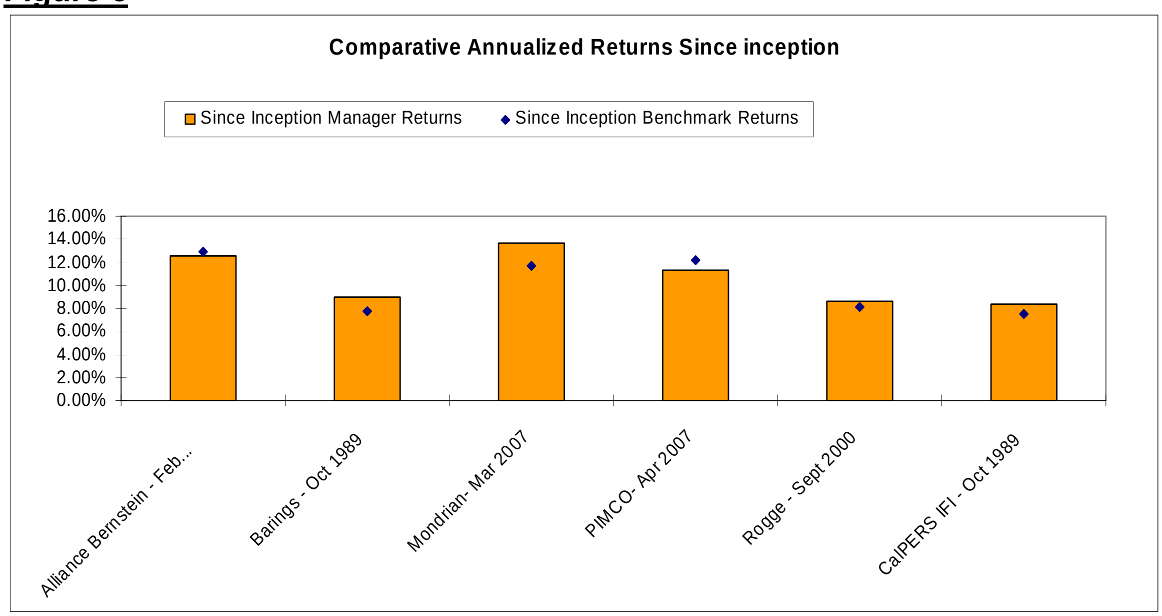


Source: State Street Bank and CalPERS

Variations in performance during the review period for the above managers reflect different styles and forecasts.

Figure 6 below shows the annualized returns of the managers and the program as a whole since inception. Note that inception dates vary among managers.

Figure 6



Source: State Street Bank and CalPERS

The difference in benchmark returns amongst these managers is due to varying inception dates. The key measure is performance relative to the benchmark. Individual manager performance detail and sources of positive or negative performance is provided on pages 12 through 17.

Below, Table 6 details information and Sharpe ratios for Baring and Rogge, who have served CalPERS for time periods long enough to calculate meaningful ratios. These ratios are calculated using monthly return data for the previous 3- and 5-year periods. Information and Sharpe ratios for managers hired in 2007 are shown for the one-year review period below in Table 7. Due to the very short time period that the newly hired firms have managed CalPERS' assets, information and Sharpe ratios for them are less meaningful.

Table 6

Active Managers	Average 3 year Information Ratio	Average 3 year Sharpe Ratio	Average 5 year Information Ratio	Average 5 year Sharpe Ratio
Baring Asset Mgmt.	-0.25	-0.05	-0.12	-0.02
Rogge Global Partners	0.63	0.11	0.62	0.08

Source: State Street Bank and CalPERS

Table 7

Active Managers	One Year Information Ratio	One Year Sharpe Ratio
Alliance Bernstein	-0.45	-0.13
Mondrian	1.10	0.31
PIMCO	-0.34	-0.06

Source: State Street Bank and CalPERS

Individual Managers Performance and Evaluation

Alliance Bernstein LP

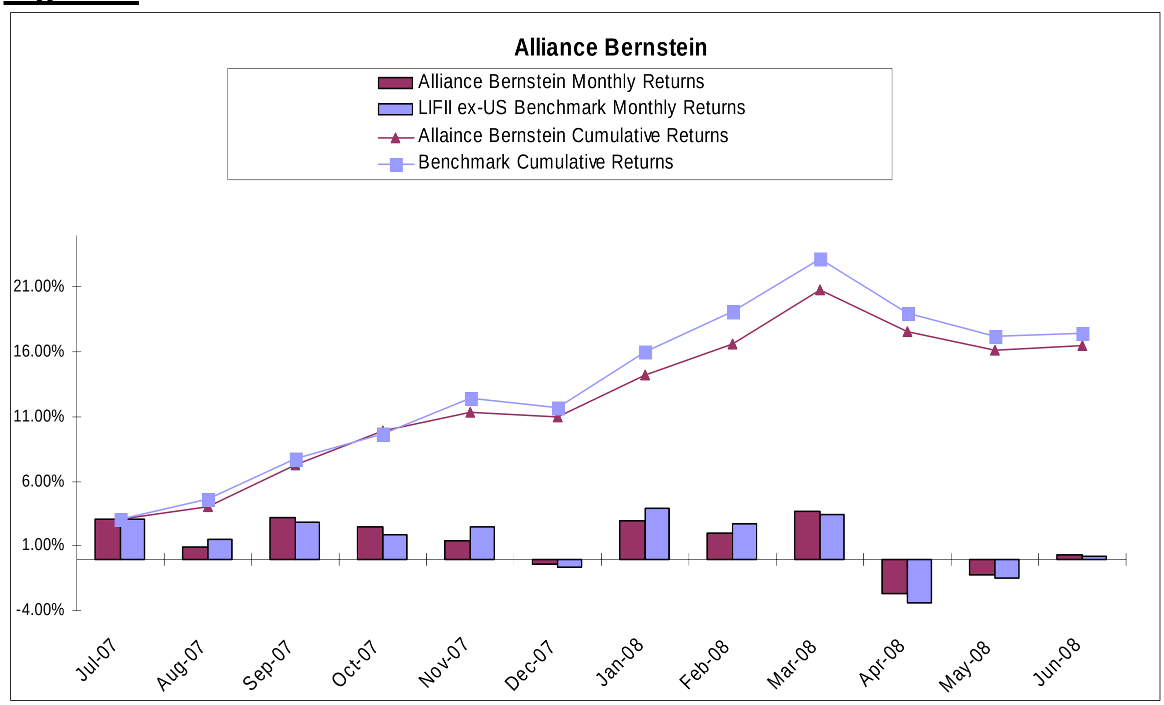
Alliance Bernstein employs an actively managed global bond strategy with a research-driven investment approach. The manager invests in the sovereign debt of developed countries, investment-grade credits, agencies, mortgages, commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS), and takes opportunistic positions in high-yield and developing country debt.

They believe inefficiencies in the global debt markets arise from investor emotion, market complexity and conflicting investment agendas. Resulting mispricings in securities and sectors provide the largest probability of generating alpha. Alliance exploits these inefficiencies through credit research and economic analysis. Quantitative techniques are employed throughout the investment process to validate and optimize opportunities.

Since inception in February 2007, the portfolio has returned 12.60%, compared to 12.89% for the benchmark, an underperformance of -0.29%. For the review period ending June 30, 2008, the portfolio returned 16.51% compared to 17.49% for the benchmark. Most of Alliance's underperformance of -0.98% can be attributed to allocations to the U.S. bond markets and corporate credit in a period of generally widening credit spreads.

The monthly breakdown of this period is shown in Figure 7 below. As of June 30, 2008, Alliance had $1,260.3 million in assets under management.

Figure 7



Source: State Street Bank and CalPERS

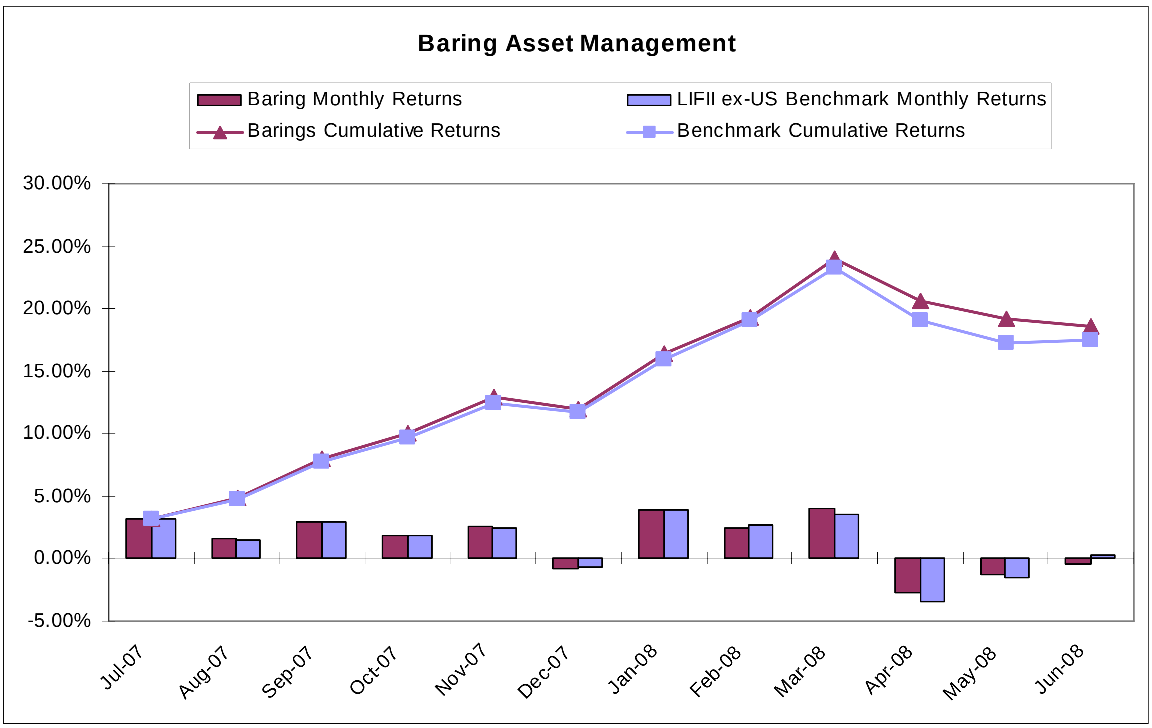
Baring Asset Management

Baring's investment philosophy is fundamental in nature, based on the belief that superior performance can be generated by understanding what markets have already discounted and where the consensus is positioned. Through their four-step portfolio construction process and multiple scenario analysis, Baring's objective is to add value through sovereign, corporate, and currency strategies while reducing return volatility.

Since inception in October 1989, the portfolio has returned 9.03% annualized, compared to 7.72% for the benchmark, an outperformance of 1.31% per year. For the review period ending June 30, 2008, the portfolio returned 18.60% compared to 17.49% for the benchmark. Most of Baring's outperformance of 1.11% can be attributed to correct decisions in country and currency allocations.

The monthly breakdown of this period is shown in Figure 8 below. As of June 30, 2008, Baring had $132.7 million in assets under management.

Figure 8



Source: State Street Bank and CalPERS

Mondrian Investment Partners

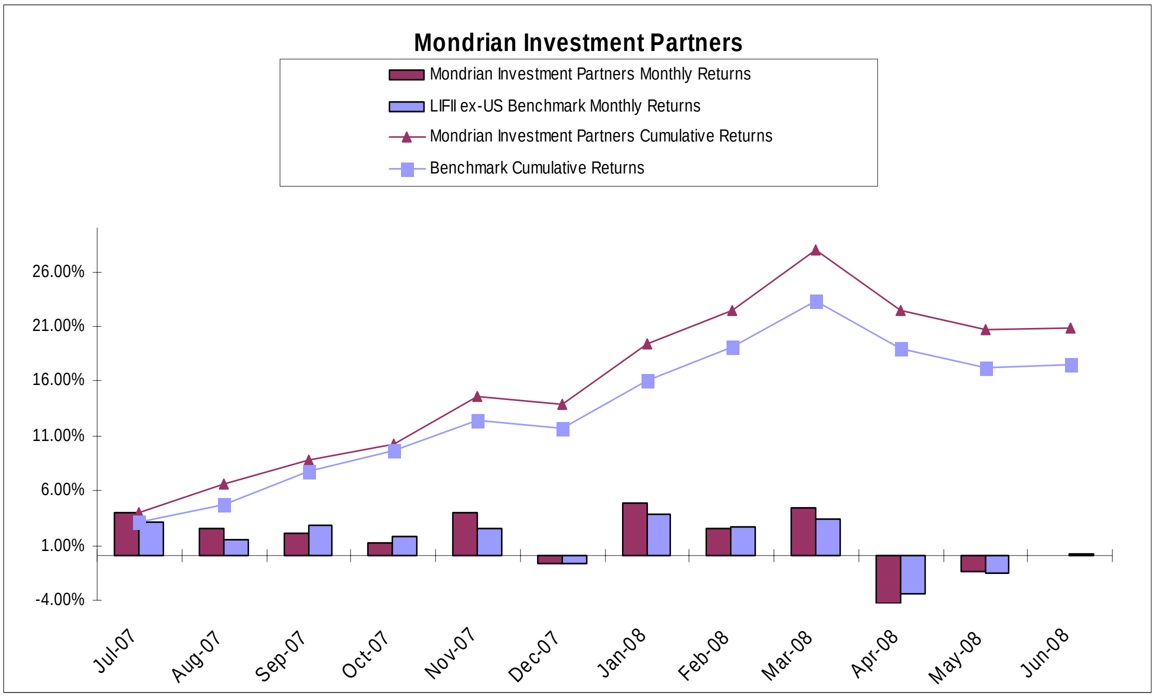
Mondrian seeks to follow a value-oriented defensive investment approach reflected in three specific investment objectives: 1) a return that exceeds inflation; 2) preservation of capital during market declines; and 3) performance to outperform the benchmark index over a full market cycle.

Mondrian combines statistical quantitative techniques with qualitative assessments in its decision making. Purchasing power parity is key to Mondrian's currency management, which is used defensively to protect the higher real returns sought by investing globally.

Since inception in March 2007, Mondrian has returned 13.69% compared to 11.71% for the benchmark, an outperformance of 1.98%. For the review period ending June 30, 2008, the portfolio returned 20.79% compared to 17.49% for the benchmark. Most of Mondrian's outperformance of 3.30% can be attributed to defensive allocations exclusively to government bonds as well as their country and currency allocations.

The monthly breakdown of this period is shown in Figure 9 below. Assets under management as of June 30, 2008 were $903.9 million.

Figure 9



Source: State Street Bank and CalPERS

Rogge Global Partners

Rogge utilizes a fundamental approach based on the analysis of longer-term financial and economic trends, and their implications for the interactions between interest rates and exchange rates. Active in country/currency allocation decisions, Rogge pays particular attention to total debt, saving rates and monetary growth, as well as the credibility of monetary authorities, in determining the relative health of a given country.

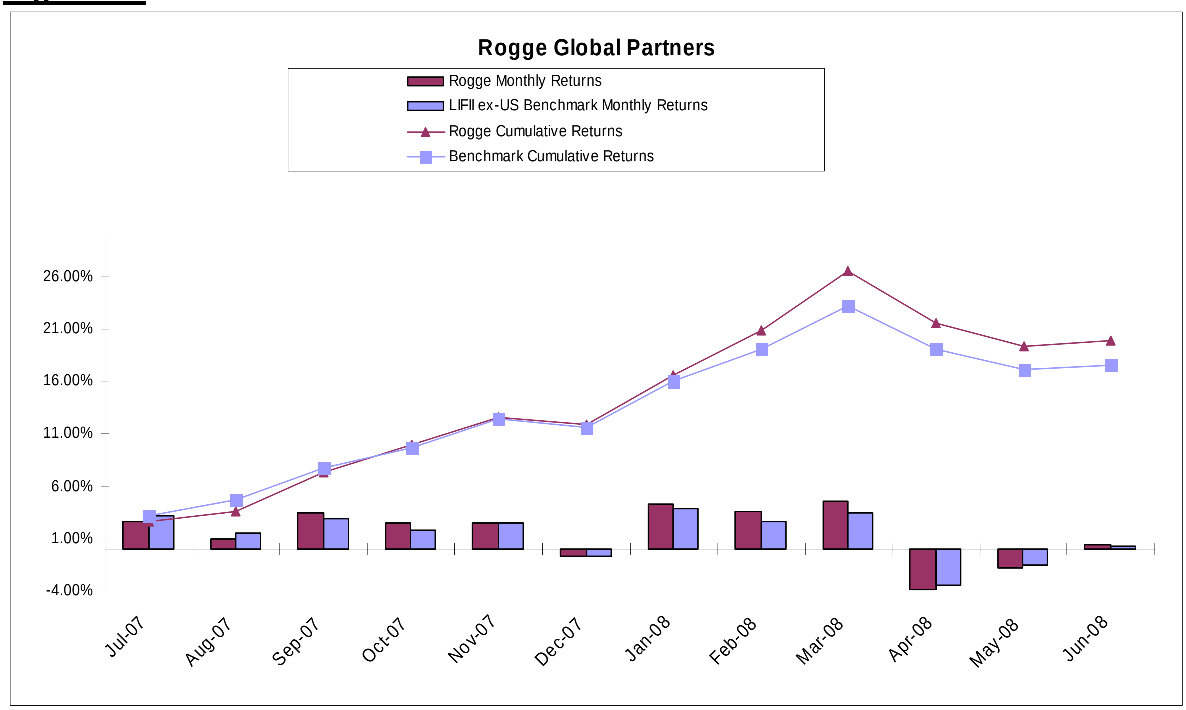
Rogge has a four step process: 1) Relative Value Analysis, 2) Portfolio Modeling, 3) Micro Level Analysis and 4) Implementation. The primary source of Rogge's alpha is country & currency selection, although duration and to a lesser extent sector and security selection also add value.

Rogge's allocation tends to be heavily concentrated in a relatively small number of markets that are expected to outperform the index. The risk of these positions is closely controlled via the tracking error defined in their mean-variance model. Rogge also determines a proposed credit allocation for a given tracking error.

Rogge was funded by CalPERS on September 1, 2000. Since inception Rogge has returned 8.58% annualized, compared to 8.16% for the benchmark, an outperformance of 0.42% per year. For the review period ending June 30, 2008, the portfolio returned 19.94% compared to 17.49% for the benchmark. Most of Rogge's outperformance of 2.45% can be attributed to correct country and currency allocations.

The monthly breakdown of this period is shown in Figure 10 below. Assets under management as of June 30, 2008 were $1,184.2 million.

Figure 10



Source: State Street Bank and CalPERS

PIMCO

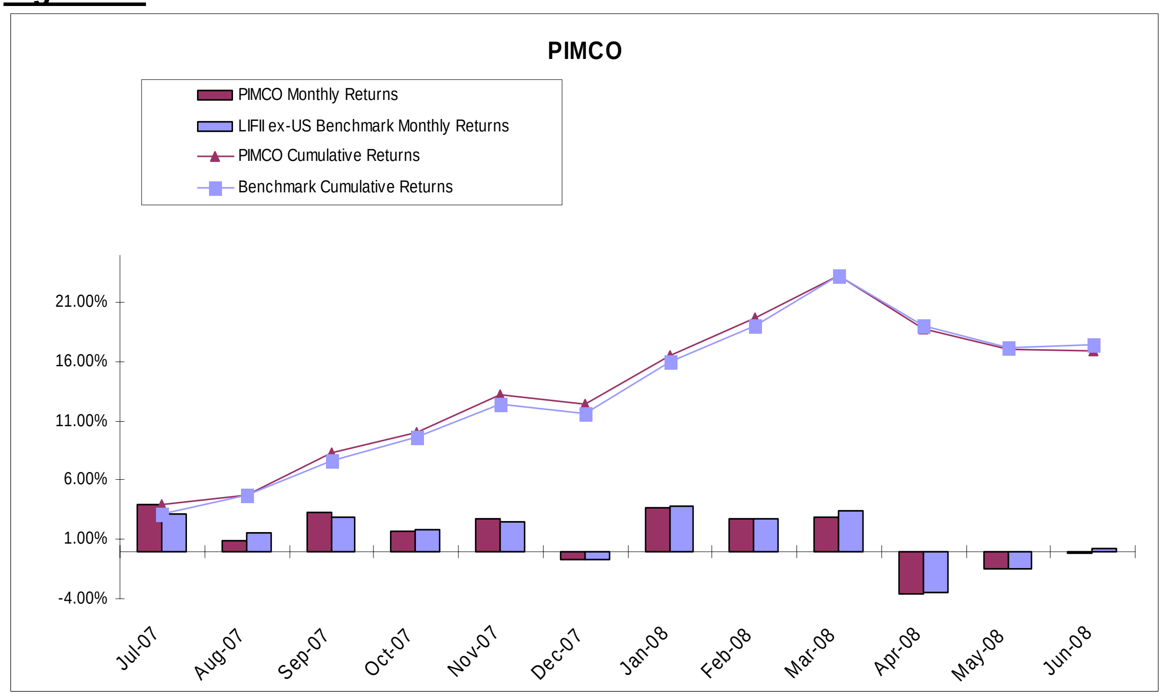
PIMCO's International fixed income investment follows four key principles: 1) carefully monitor the volatility of portfolios with respect to their assigned index; 2) use multiple sources of value added from "top-down" to "bottom up" strategies to produce consistent above-index performance; 3) separate bond and currency decisions in order to manage two distinct types of risks – fixed income risk and currency risk; 4) use advanced proprietary quantitative tools to measure and monitor risks.

PIMCO believes that analyzing secular economic and political influences is fundamental to sound portfolio decisions. The firm considers secular analysis to be so important that it devotes one week each year to what it calls its "Secular Forum." Selected members of the investment staff are assigned specific areas to monitor throughout the year, including monetary and fiscal policy, demographics, international trade and capital flow issues, inflation, and productivity trends. At the Secular Forum, these internal presenters join with outside speakers to address these issues for the firm's investment professionals. The Secular Forum results in an outlook for fixed income assets in each of the major regions of the world over the next 3 to 5 years. PIMCO's investment professionals refine these forecasts over a shorter term, or cyclical horizon every quarter at its "Economic Forums." The firm's cyclical forecasting process results in an explicit forecast for near term growth and inflation in each of four regional blocs in the global economy.

Since inception in April 2007, PIMCO has returned 11.37% compared to 12.21% for the benchmark, an underperformance of 0.84%. For the review period ending June 30, 2008, the portfolio returned 16.93% compared to 17.49% for the benchmark. Most of PIMCO's underperformance of -0.56% can be attributed to allocations away from foreign government bonds to U.S. bonds and corporate credit.

The monthly breakdown of the period under review is shown in Figure 11 below. As of June 29 2007, PIMCO had $1,241.5 million in assets under management.

Figure 11



Source: State Street Bank and CalPERS

V. STRATEGIC PLAN:

External investment manager performance is monitored by staff and reported to the Investment Committee per CalPERS Strategic Plan, Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX: Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The purpose of this item is to keep the Investment Committee informed of staff's efforts to ensure that the international fixed income external manager program is performing in line with expectations. All results shown are net of management fees.

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